CHASE

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## Changing of the Guard in Germany

The replacement of Chancellor Schmidt's government by a right-of-center coalition led by Helmut Kohl appears to signal a mild shift in Germany's fiscal policy. It also further reduces the chances, at least in the short run, of Germany leading Europe out of its longest and, in many ways, costliest postwar recession.

The fiscal strategy of the new government entails a shift in the composition of public expenditure—away from transfer payments to individuals and toward greater investment incentives for industry. At the same time, the new government, like its predecessor, is hoping to reduce the public-sector deficit. While such a policy should lead to long-term structural improvements, its short-run effect on economic activity depends largely on raising private investment by more than it would reduce private consumption. It is here that a number of additional influences come into play, including: the reaction of Germany's capital markets, actual and expected shifts in Bundesbank policy, and—by no means least important—the expected and actual outcome of a general election, likely to be held next March.

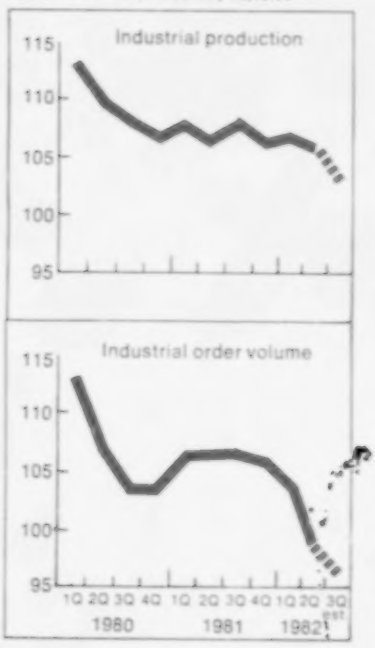
A favorable reaction by the capital markets—meaning a reduction in long-term interest rates from the current yield of over 8.5% on government bonds—depends in part on the market's perception that the authorities will succeed in lowering the public sector's appetite for funds. Uncertainty regarding the outcome of a March election is likely not only to weaken this perception, but also to depress private investment in the short run.

Another consideration is the Bundesbank's reaction to the prospect of a lower public-sector deficit. The central bank has argued that lower public deficits would be helpful to easing key short-term interest rates. However, the primary obstacle to a faster reduction in German money-market interest rates has in recent months been the strength of the U.S. dollar, rather than domestic considerations. And while both the deepening recession and the gains made in bringing down Germany's underlying rate of inflation are likely to reduce the relative weight the Bundesbank assigns to external forces, it does not follow that the central bank has altogether abandoned its commitment to the exchange rate.

In sum, the short-term economic impact of recent political events in Germany is likely to be more dampening than expansionary. And the reaction of the markets—both domestic and international—to the policies of the new government will play a large part in determining the course of the economy over the near term.

Germany's industrial output and orders

*Index: 1976=100, seasonally adjusted*

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*Austrian turnaround awaits German economic recovery.*

The export-dependent Austrian economy appears to have taken a turn for the worse. Surveys conducted in late summer show that both domestic and export orders are falling. The mid-year production declines in the rest of Europe, particularly in Germany, are now being felt in Austria. The Austrian Institute for Economic Research just recently revised down its 1982 growth forecast to 1% from 2% predicted earlier. On the brighter side, the year-on-year inflation rate has fallen to 5.1% in August from just under 7% at the end of last year, and the current account of the balance of payments has shown a 3.5 billion schilling surplus in the first seven months of 1982, compared with a year-earlier deficit of 9.4 billion. Despite these favorable developments, a sustained upturn in Austria must nevertheless await recovery in Germany, which, at present, is not expected before the second half of next year.

*Continued economic retrenchment inevitable for Ireland.*

Ireland's senate was recalled from its summer vacation to debate the country's economic situation—an indication of the severity of the problems the government continues to face. Despite its tiny majority, the government has tried to impose some tough policies. Public-sector employees have been held to a stringent pay policy and taxes have been raised substantially in an effort to contain perennial budget deficits. The resultant unpopularity of these programs has led to speculation that a new election will be called before long. There are, however, signs that the government's policies are beginning to work: Ireland's persistently stubborn inflation peaked at a year-on-year rate of 21% in May and then dropped to 17% in August; further falls are expected. The trade deficit has totalled 960 million pounds so far this year, compared with 1.3 billion over the same period last year. The prime rate has been reduced from August's 19% level to 16% and additional reductions are hoped for. Still, the changes recorded to date are no more than a reversal of some worrisome trends. Ireland will have to continue with tough policies for a long time yet before its situation really improves—regardless of which party is in power.

*Spanish economy still weak, but balance of payments improved.*

With elections scheduled for the end of October, the Spanish economy is showing only minimal signs of emerging from recession. The positive signs are a 17% growth in the value of exports in the first four months of the year, an encouraging tourist season, and industrialists' continuing optimism over order books. But, on the whole, despite some stimulative effects from the burgeoning public deficit, the economy is still weak. Industrial production fell 0.6% (year-on-year) in April, housing starts declined 8.8% over the first five months of 1982, and unemployment has continued to rise. Also, weather conditions have remained unfavorable, which should limit the improvement in agricultural output after last year's drought. With inflation also rising, the only really good news is the improvement in the balance of payments. In the first half of the year, the current-account deficit fell to $3.2 billion, down from $4.1 billion in 1981's first half.

*Venezuela moves to bolster international position.*

The Venezuelan government has undertaken two measures to strengthen its international financial position. In order to boost the level of official international monetary reserves, the government has pooled the foreign-exchange holdings of state-owned companies with those of the central bank. Also, official gold holdings have been revalued at $300 per ounce. With these actions, international reserves are now estimated at $16 billion, compared with $6.1 billion in August. Another $2.3 billion is held by the government's Venezuela Investment Fund but is not included in central-bank reserves. The government also has proposed to commercial banks that they convert part of Venezuela's $8.8 billion of short-term external debt into longer maturities. This would improve the maturity profile of the country's total external public debt of $18.8 billion. By calling attention to the fact that Venezuela's international monetary holdings approximate the size of its total external public debt, the government hopes to impress the world financial community that the country is in a relatively good position compared with some other Latin American nations.

*Peru cuts public spending in accordance with IMF goals.*

The Peruvian government has been restraining public expenditures in an effort to meet the targets established with the IMF. Under an IMF-Peruvian government stabilization plan agreed to earlier this year, the public-sector deficit was to be held to 4.2% of GDP. The June 30 goals of the stand-by arrangement were met and a disbursement by the IMF was made in August. In an attempt to meet the next fiscal targets for September 30 the government enacted new cuts in 1982 expenditures and reduced food subsidies. The efforts to slow the public-sector spending have come at a time of declining overall activity. Real GDP expanded at a 4.5% rate in the first quarter of 1982 but slowed to only 0.1% in the second quarter. Manufacturing and construction have been especially hard hit. The balance of payments, however, has improved as a consequence of lower imports and rising oil sales. Net international reserves have also been augmented, which should help Peru to meet another target by year-end.

*Malaysian economic slowdown expected to continue.*

Sagging demand for its key commodity exports and the resultant squeeze on its financial resources have forced the Malaysian government to trim its projection of 1982 economic growth for the third time this year. The government is now predicting real growth of just 3.5%-4.5% in 1982—down substantially from its initial estimate of 7.2% and from 1981's actual growth of 6.5%. Moreover, the downturn in external demand is spreading to local markets. Public spending is being trimmed in response to lagging government revenues; and consumer spending is waning, as persistently low commodity prices keep agricultural incomes depressed. As a result, production in most sectors of the economy is stagnating or declining and corporate profits are down. The government has indicated that its 1983 budget, to be announced later this month, will be only mildly expansionary. Thus, a revival of economic growth will depend primarily on increased private-sector activity. And unless the world economy rebounds strongly and soon—the signs of which are not apparent yet—the Malaysian economy may not be able to turn in a much better performance next year.

*New Bangladesh policy seeks to reestablish private-sector involvement in industry.*

Bangladesh's ambitious new industrial policy has made significant advances in the direction of opening up the economy to private enterprise. The new policy, announced in June, expanded the number of industries open to both public and private sectors and dramatically reduced the number of industries reserved as public monopolies. In addition, in order to improve the efficiency and profitability of public-sector corporations, the government has indicated that it will divest part of its holdings and will turn other enterprises over entirely to private management. In particular, the government has agreed in principal to return to private ownership the textile and jute mills nationalized under a previous administration. However, it still remains to be seen whether the government can successfully implement its new industrial policy. Moreover, the recent ban on the domestic production and sale of certain drugs is a sign that the government will continue to intervene in industry in certain circumstances.

*Economic rebound forecast for Senegal.*

After two successive years of decline, when real GDP fell by an average of more than 6% per year, the Senegalese economy appears to be turning around. Real output is forecast to grow by 6% to 7% in 1982. Favorable weather produced the first good harvest in three years; industrial production is expected to rise by 7%; and investment is likely to show considerable gains this year and next, as work begins on various industrial and infrastructural projects. In the external sector, last year's record current-account and overall balance-of-payments deficits were somewhat eased by the consolidation and rescheduling of $83 million of bilateral debt. The remaining financing gap was closed by EEC funds and IMF credits. This year's outlook is for a significant narrowing of the deficits, owing to a restraint on imports and the rescheduling of some $80 million of commercial bank debt. The 1982 current-account deficit is forecast to decline to $270 million, from $446 million last year, and the overall gap is expected to shrink to $66 million, from $187 million.

# New Financial Options: Promise and Problems

After several delays, the Chicago Board of Trade (CBOT) inaugurated trading this month in options on Treasury-bond futures. The new contract is part of the Commodity Futures Trading Commission's (CFTC) three-year pilot program permitting the trading of several commodity option contracts through organized futures exchanges. Because of the flexibility they offer speculators and hedgers, the options provide these traders with an advantage over existing bond futures. Moreover, although they have several obstacles to overcome before attracting enough volume to ensure an adequately liquid market, the options could become an important force in stabilizing prices in the cash market.

The new option contracts, which are "written"—or sold—to other investors, are of two types. The *call option* gives a buyer the right to purchase a Treasury-bond futures contract at a given price—known as the exercise or striking price—within a specified amount of time. The *put option*, on the other hand, gives the buyer the right to sell the underlying futures contract at the striking price on or before the expiration date. The futures contract, by contrast, calls for the delivery of the underlying security—in this case a Treasury bond—at a predetermined date and at a specified price: the futures price.

Both securities offer market participants an opportunity to contract for the future delivery of a bond at a price determined today. In addition, both vehicles give traders a substantial degree of leverage, although in different ways. With futures, investors put up a small percentage of the value of the futures contract as margin, which must be maintained on a daily basis by a procedure known as "marking to the market." That is, if the futures price moves favorably, the investor may remove the surplus, but if it moves adversely, additional margin must be paid. With the option, on the other hand, the leverage arises from the option price, or premium, the investor must pay to buy the contract, which is typically less than 10% of the value of the underlying security. Thus, with the futures contract, the sole initial investment is the margin; the futures price, at which the underlying security will ultimately be traded, fluctuates daily in the market. With the option, on the other hand, it is the premium—or initial investment—that is market-determined, while the striking price is arbitrarily fixed. Consequently, with the option the investor cannot lose more than the initial investment, whereas the investor in futures contracts could face potentially unlimited losses in the event of an adverse price move.

The new options allow speculators to profit and hedgers to protect themselves from changes in long-term interest rates. For instance, the buyer of a call option will profit if rates fall and push the price of the underlying futures contract above the striking price by more than the amount of the original pre-

## Asia and Oceania — Bimonthly Survey of Business and Finance

| | COUNTRIES | CURRENT BUSINESS CONDITIONS | EXPORTS | | GNP IN 1981 | | BALANCE OF P | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | 6 months ending | 12-month change | in billions of dollars | $ per capita | latest data | reserves (less gold) in million $ | 12-month change | months of imports covered | use of credit, lions of d |
| Asia | Bangladesh | Scope for private-sector investment expanded; phased divestment of public holdings planned. | April | 14% | 11.6* | 126 | Aug. | 169 | – 24% | 0.8 | 408 |
| | Burma | Strong growth expected, thanks to isolation from world economy and good rice crop. | Jan. | 3% | 5.3* | 146 | Aug. | 105 | 60% | 4.0 | 50 |
| | China, People's Republic | Strong domestic growth forecast owing to recovery in heavy industry and good harvest prospects. | June | 10% | 260.0 | 260 | May | 6.556 | – 54% | 3.6 | 492 |
| | Hong Kong | Concerns arising from China lease question affecting property, financial markets. | June | – 7% | 24.2 | 4.695 | n. a. | — | — | — | — |
| | India | Despite recent rains, earlier drought expected to depress foodgrain production and overall growth. | March | 17% | 161.4* | 236 | April | 4.765 | – 27% | 4.4 | 1.913 |
| | Indonesia | Slump in foreign earnings continues to depress activity. | Dec. | – 4% | 77.5 | 500 | March | 5.235 | 15% | 4.5 | 0 |
| | Japan | Consumer spending may have weakened; investment plans being pared; fiscal stimulus likely. | July | 6% | 1.130.3 | 9.690 | Aug. | 24.415 | – 11% | 2.2 | 0 |
| | Korea | First-half growth 4.6%; business stimulation package spurs slow recovery. | July | 1% | 63.4 | 1.638 | Aug. | 2.333 | 6% | 1.2 | 1.247 |
| | Malaysia | Government growth estimate for 1982 now trimmed to 3.5%–4.5%. | April | 8% | 23.6 | 1.618 | June | 3.382 | – 14% | 3.4 | 269 |
| | Nepal | Fiscal 1982-83 budget calls for large increase in development spending. | June | 33% | 2.4* | 157 | May | 216 | – 16% | 6.6 | 17 |
| | Pakistan | Poor export performance depressing domestic activity. | June | 23% | 30.7 | 359 | Aug. | 1.164 | 47% | 2.7 | 1.178 |
| | Philippines | Coconut levy abolished but copra exports banned. | Dec. | 10% | 38.6 | 780 | Aug. | 1.825 | 20% | 2.6 | 857 |
| | Singapore | Construction, financial services sectors buoyant; manufacturing depressed by weak exports. | June | 3% | 12.5 | 5.121 | May | 7.589 | – 14% | 3.2 | 0 |
| | Sri Lanka | Election later this month will determine path of economic policies. | March | – 4% | 4.4 | 291 | Aug. | 302 | – 28% | 2.3 | 394 |
| | Taiwan | Economic growth was only 3.5% in first half 1982; weak world demand acts as drag. | April | – 4% | 45.5 | 2.510 | April | 7.648 | – 168% | 4.7 | 0 |
| | Thailand | Domestic demand depressed by low commodity prices; growth may be under 5%. | May | 5% | 36.1 | 750 | Aug. | 1.472 | – 6% | 2.1 | 638 |
| Oceania | Australia | Budget finances income-tax cuts, increased family assistance through higher sales taxes. | Aug. | 3% | 159.4 | 10.724 | Aug. | 3.581 | – 66% | 1.5 | 0 |
| | New Zealand | Budget cuts income taxes as quid pro quo for wage freeze, raises sales taxes. | June | 3% | 24.4* | 7.858 | Aug. | 454 | – 23% | 0.9 | 12 |

*Fiscal year. †Previous fiscal year.

mium. If rates do not fall, the holder simply does not exercise the option, and the only loss is the original premium. Similarly, to profit from rising rates, the speculator would buy a put option. Moreover, nonfinancial corporations can buy put options to hedge against rising financing costs, while pension funds and other institutions or individuals can earn additional income from option premiums by writing call options against portfolios of bonds they own.

Because of the potentially large number of traders, many observers expect the options market to be quite active, although volume in the first few days has been extremely light. The dearth of initial interest has been attributed to the public's lack of familiarity with this complex instrument, but there are other obstacles as well. First, options on commodity futures contracts were the vehicle of fraudulent activities on the part of several small firms in the 1970s. And although the CFTC has issued stiff regulations to ensure the legitimacy of the new contracts, some investors still have lingering suspicions to overcome. Second, until the market becomes well-established, newspapers do not intend to report price quotations on their financial pages. In the interim, however, the CBOT will list closing prices in serialized advertisements. Finally, although the market would be deepened by the listing of financial-futures options on other exchanges, the main securities exchanges cannot currently do so. They are regulated by the Securities and Exchange Commission, which has no authority to regulate options on futures contracts.

If these problems can be overcome, however, options could serve to stabilize bond prices in the cash market by providing investors greater flexibility than futures contracts. The lack of a "mark-to-market" feature on the option allows an investor to suffer an adverse price movement without being forced out of the market. With futures, such circumstances would call for the posting of additional margin and, when the margin calls cannot be met, for the closing of the positions. Consequently, if bond prices fall dramatically, some long futures positions could be closed, increasing selling pressure in the market and worsening the price decline. Similarly when prices rise sharply, some short positions could be closed, and the resulting buying pressure could further boost the price rise. When interest-rate speculation is accommodated by options, on the other hand, price fluctuations may not be intensified by developments in the ancillary market. When adverse price movements occur, the options are simply not exercised, so that no additional pressure is created to magnify the price movement.

Because of the close connection between the cash market and the futures market, price fluctuations in the two markets tend to be highly correlated. As a result, the influence of volume changes on the futures and options markets tends to be reflected in price movements in the bond market itself. Thus, to the extent that the introduction of the options market will encourage more speculative and hedging activity to be done through options, bond prices may tend to become relatively more stable. *Carl Alan Batlin*

| YMENTS | | MONEY AND BANKING | | | | | | COUNTRIES |
|---|---|---|---|---|---|---|---|---|
| F<br>l-<br>lars | current influences on payments | 12-month changes<br>latest data | consumer prices | latest data | money supply(M1) | exchange rate in U.S. dollars<br>October 6, 1982 | change from year earlier | current monetary conditions | |
| | SDR 71.2 million drawn under Compensatory Financing Facility. | June | 6% | May | 1% | .0443 | 31% | Credit continues restrictive. | Bangladesh |
| | Reserves have declined sharply since mid-1981. | Jan. | 2% | Apr.'81 | 13% | .1267 | 10% | Kyat remains pegged to SDR. | Burma |
| | Jan.-June trade surplus was $2.4 billion; import restrictions continue. | Dec. | 3% | March | 16% | .5191 | 8% | Increased personal savings boosts housing construction. | China, People's Republic |
| | Exports remain disappointing; HK dollar weak. | Aug. | 11% | July | 10% | .1577 | 5% | Bank run an isolated incident. | Hong Kong |
| | Exports hurt by weak world demand, textile strike; foodgrain imports necessary. | June | 7% | March | 7% | .1032 | 7% | Deposit growth slows. | India |
| | Oil prices unchanged; first counterpurchase agreement signed. | June | 9% | April | 32% | .00149 | 7% | Government tightens money grip to moderate inflation. | Indonesia |
| | Exports depressed by world recession, trade restraints; weak yen no help. | Aug. | 3% | July | 5% | .00363 | 17% | Weak yen continues to prevent further monetary easing. | Japan |
| | Despite sluggish exports, trade deficit narrows owing to weak imports. | July | 5% | June | 14% | .001347 | 8% | Easier monetary policy adopted. | Korea |
| | Slack demand, depressed commodity prices pull down exports. | July | 5% | May | 10% | .4212 | 2% | Net foreign borrowing for 1982 forecast at $1.7 billion. | Malaysia |
| | Customs duties on luxury imports raised; incentives given to exports. | June | 9% | Jan. | 14% | .0758 | 5% | Regulations on credit and loans simplified. | Nepal |
| | Fiscal 1981-82 current-account deficit now estimated at $1.53 billion. | June | 9% | July | 14% | .0805 | 21% | Depreciation of rupee slowed. | Pakistan |
| | Recent interest-rate drop lowers debt servicing costs. | June | 13% | July | 1% | .1151 | 11% | Gov't. announces plans to lift remaining interest ceilings. | Philippines |
| | Exporters complaining about strength of Singapore dollar. | July | 2% | May | 8% | .4575 | 5% | Nominal rates lower but real rates remain high. | Singapore |
| | Depressed prices for tea, rubber, coconut products hurt exports. | June | 11% | May | 21% | .0478 | 9% | Rupee shows little movement. | Sri Lanka |
| | Import restrictions on Japanese goods lifted. | April | 4% | April | 9% | .0251 | 10% | Deposit ceiling for foreign bank branches raised. | Taiwan |
| | Commodity exports show strong volume increases, thanks to '81's good harvest. | July | 5% | Dec. | 2% | .0435 | 3% | Domestic interest rates ease. | Thailand |
| | Overall deficit recorded in July as capital inflow slows. | June | 11% | July | 1% | .9492 | 18% | Government reaffirms commitment to 9%-11% target. | Australia |
| | Current-account deficit widens because of imports for energy projects. | June | 17% | March | 15% | .7184 | 14% | Routine monthly adjustment of NZ$ against US$ suspended. | New Zealand |

# World Interest Rates

*market rates of Oct. 6, 1982; bond yields as of Oct. 1, 1982*

| in percent per annum | U.S. | Canada | Britain | Belgium | France | Germany | Italy | Netherlands | Switzerland | Japan |
|---|---|---|---|---|---|---|---|---|---|---|
| **Central Bank Discount Rate** | 10.00 | 12.98 | 10.125 intervention rate | 12.50 | 9 50 | 7.00 | 18.00 penalty rate 21.00 | 7.00 | 5.00 | 5.50 |
| **Day-to-Day Money** | 9.75 October 7 | 15.00 | 10.50 | 11.80 | 14.00 | 7.80 | 18.50 | 8.875 | 1.50 1-month Euro-Swiss fr. rate | 7.0625 |
| **Treasury Bills** 91-day, Middle Rates | 8.05 | 12.75 | 9.9375 | 12.75 | n. a. | n. a. | 16.151 85 days | no dealing | no market | 5.625 two-month |
| **Commercial Paper** prime, 3-month, asked | 10.75 finance paper discount basis | 13.15 finance paper 15% tax w/h | 9.706 | 12.20 Certified | 14.00 Interbank | no market | no market | no market | no market | not traded |
| **Bankers' Acceptances** 3-month, asked | 10.30 | 12.85 15% tax w/h | 9.875 | 12.40 Certified | not traded | 8.50 | 19.70 | no market | 4.1875 | no market |
| **Government Bonds** Long-term, new and old issues, average yield | 11.58 | 13.38 | 10.85 | 9.849 20% tax w/h | 15.60 | 8.41 | 19.16 | 9.99 | 4.44 | 8.182 |
| **Industrial Bonds** prime, long-term, new and old issues, average yield | 13.30 Aa Industrials | 14.75 | 12.53 | 15.427 | 16.37 | 8.46 | 19.70 | 10.82 | 5.94 | 6.70 |
| **Bank Short-Term Rate** to Best Borrowers (prime rate) | 13.50 | 15.00 | 10.00 October 7 | 16.25 | 16.05 | 11.50 | 20.75 ⅛ qtrly fee on outstdng. | 9.50 | 9.00 | 6.00 |
| **Bank Time Deposits** 3-month | 10.50 Cert. of Dep. | 13.25 | 10.375 | 12.70 | 14.00 | 8.00 | 11.50 | 7.875 large deposits | 3.25 residents only | 3.75 |
| **Eurocurrencies** 3-month, asked | 11.75 | 13.375 | 10.50 | no market | 17.125 | 7.625 | no market | 7.75 | 4.1875 | 7.3125 |
| **Exchange Rates—in U.S.$** rates floating against the $ | — | .8068 | 1.6875 | .0202 | .1383 | .3910 | .000695 | .3581 | .4540 | .003636 |
| **Forward Exchange Cover** 3-month, in percent p.a. *D* = discount, *P* = premium | — | 1.75 *D* | 1.25 *D* | 1.50 *D* | 5.50 *D* | 4.25 *P* | 7.75 *D* | 4.00 *P* | 7.50 *P* | 4.50 *P* |

**Eurodollar Deposits**
(London, interbank, bid)
October 7

| | |
|---|---|
| 7-day | 10.5625 |
| 1-month | 11.00 |
| 3-month | 11.375 |
| 6-month | 11.6875 |

**International Arbitrage**
(3-month, hedged) + *in favor of U.S. dollars*

| | |
|---|---|
| U.S.-U.K. Treasury Bills | −0.501 |
| U.S.-Canada Treasury Bills | −2.388 |
| U.S.-Canada Finance Co. Paper | −0.470 |
| Eurodollars-U.K. Local Auth. Deposits | +2.688 |

**Eurobonds**
(average yield on recent straight debt issues)

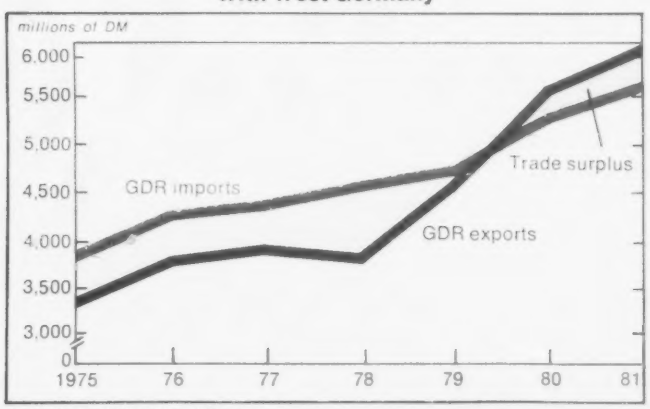
| | |
|---|---|
| U.S. Dollar Bonds | |
| 7 yrs. and under | 12.75 |
| Over 7 yrs. | 13.125 |
| DM Bonds | |
| 7 yrs. and under | 8.375 |
| Over 7 yrs. | 8.625 |

**Gold Price**
London afternoon fixing
404.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

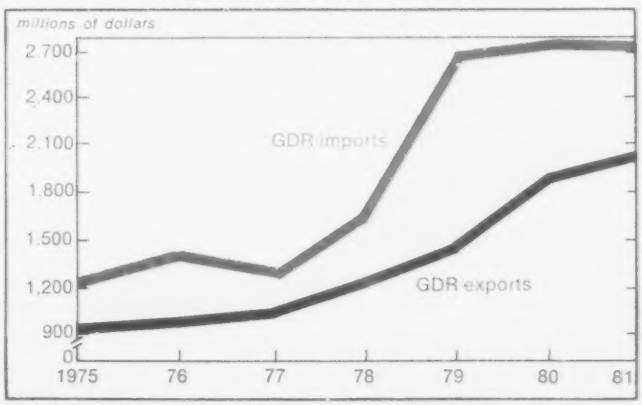
## Foreign Trade of the German Democratic Republic

### With West Germany




*Data: Federal Republic of Germany*

### With other OECD nations




*Data: International Monetary Fund*

# GDR: Learning to Cope With Less

Since 1980, all of Eastern Europe has experienced a difficult period of austerity and adjustment, an ordeal caused by errors in domestic policies as well as pressures from the Soviet Union and Western credit markets. In the case of the German Democratic Republic (GDR), a basic strategy for structural adjustment in the 1980s had been designed as early as 1979. All combines and ministries had then been directed to reconsider their investment plans and project designs to take account of rising costs for energy and raw materials and the limitations on future Soviet deliveries of such commodities.

External developments during 1981 led GDR planners to accelerate the adjustment process. The most significant of these was the situation in Poland with its consequences for Soviet financial strength and the availability of Western credits. The direct impact of Poland's economic collapse on the GDR was serious but not catastrophic. Poland's exports to the GDR—metallurgical coal, electrical machinery and consumer products, primarily—had been declining in volume since 1977 and substitutes could be found in Western or Eastern markets during 1981, albeit at higher cost.

Even without the Polish crisis, however, adverse conditions in the world economy during 1981 would have pushed the GDR toward import restrictions. The deepening recession in the West—particularly severe in the European Community—reduced both the volume and prices of GDR exports of manufactured products. High nominal interest rates, positive real interest rates, and a strong dollar increased the burden of external debt. In this situation, problems with the rescheduling of Polish commercial debts reduced the volume of Western credits available, raised the price on new credits to borrowing Council for Mutual Economic Assistance (CMEA) countries, and shortened the maturity structure of GDR debt.

Another influence was the deteriorating economic position of the Soviet Union. Beset with a third successive harvest failure, declining production levels of coal and steel, adverse shifts in Western markets, and the pressure to cover Poland's trade and financial needs, Soviet leaders had lost patience with the more successful economies in Eastern Europe—Hungary and the GDR. Consequently, when the USSR-GDR trade agreement was finally ratified late in 1981, the GDR faced a reduction in the volume of Soviet deliveries of fuels under favorable CMEA pricing formulas. If the GDR wished to purchase more, the increment would have to be paid for at the world price—in dollars, food, consumer goods, or quality machinery.

Soviet pressures were responsible for most of the changes evident in the five-year plan (1981-85), published in December 1981. In particular, the plan called for a reduction in total capital investment over the five-year period and the establishment of a target for exports to socialist countries—an increase of 50% by 1985 or 8.4% per year. The deterioration in the prospects for East-West trade and Western credits may have reinforced those changes, but the principal determinant was the USSR decision to accelerate the GDR's trade adjustment in order to reduce the Soviet burden of trade subsidies. Cuts in capital investment were primarily in the machinery component rather than in construction. Machinery released from domestic investment could then be exported abroad. The shift in the foreign-trade target toward exports to socialist countries clearly indicates that deliveries of machinery to the Soviet Union are to receive top priority during the 1980s.

One of the most important targets in the five-year plan is the reduction of specific consumption in energy, raw materials, and supplies at an annual rate of 6.1%. This is to be accomplished in part by rationalization of existing technical processes, but most of the gains are to be achieved through redesign of products and shifts in the composition of output.

### Status of the adjustments in 1982

With only limited credit available in the West, GDR authorities slowed economic growth during 1982 in order to reduce the demand for imports and free more resources for exports. National income produced (net material product) grew 3% in the first half of 1982 relative to the first half of 1981. In comparison, national income produced increased 5% in 1981. Gross industrial output under industrial ministries grew around 4% in the first half of 1982, compared with the original target of 5.1%.

Investment expenditure during the first half of 1982 (excluding capital repair) amounted to 22 billion marks. This figure represented a decline of 6%-7% in nominal terms and an even greater decline in real terms. Furthermore, the output of the construction industry continued to grow, so investment in machinery and equipment probably fell by more than 10%. This year's reduction in machinery installation reflects the substantial cutback in imports of Western machinery and equipment as well as efforts to export a larger volume of GDR machinery to the Soviet Union.

### Foreign trade in 1981 and 1982

Recently released statistics reveal the GDR's trade results for 1981. For the first time since 1974, the Central Statistical Office published the value of exports to and imports from socialist and non-socialist countries

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separately, instead of merely reporting the trade turnover—that is, the sum of exports and imports. However, the data for bilateral trade as well as for aggregate trade with CMEA, the developed West, and developing countries are still reported only on a turnover basis. For 1981, the new data show that:

- Exports to non-socialist countries increased 27% (measured in valuta marks, a monetary unit used for accounting purposes only) in spite of the world recession.
- Imports from non-socialist countries declined 4% as hard-currency imports were restricted by financing constraints in Western capital markets.
- This adjustment eliminated the large deficits of recent years and produced the GDR's first trade surplus with non-socialist countries since 1968.
- At the same time, GDR exports to socialist countries rose less rapidly than did imports so the ruble deficit more than tripled to around 275 million rubles in 1981.

There still remain difficulties in the interpretation of GDR trade statistics—questions which pertain to exchange-rate methodology and country composition. There has always been a significant discrepancy between GDR statistics on trade with the West and mirror trade statistics of OECD countries and West Germany. But this discrepancy appears to be much larger in 1981 than in recent years. According to Western statistics, GDR exports to industrial countries actually declined more than 6% in 1981 when measured in current dollars, rather than the 27% increase implied by GDR data.

Given the inner-German clearing facility, trade transactions in deutsche marks are not fully convertible for the GDR. Moreover, around 60% of GDR exports to the West in 1980 were DM transactions and recorded as such before being converted to valuta marks. Conversion rates for dollars and DM are specified before the calendar year for guiding foreign trade organizations and GDR enterprises. Western analysts know neither how such conversion rates are determined nor how accurately they are revised at the end of the year for statistical purposes. The pattern of discrepancies between GDR and Western data suggest that dollar and DM trade transactions are not aggregated *ex post* with the average market cross-rate.

Despite the difficulties in reconciling available GDR trade data, domestic adjustments in energy and material consumption and in agriculture clearly permitted a large foreign-trade adjustment during 1981. Some portion of the export growth in the category of fuels, minerals and metals must have taken place through a reduction of inventories. Consequently, such a sizable swing is unlikely to take place again during 1982 when restocking becomes necessary.

Nevertheless, the GDR's foreign-trade adjustment continued through the first half of the year. Over that period total exports rose 10% relative to the first six months of 1981. The trade surplus with non-socialist countries grew to over 1 billion DM—an unprecedented level. The announcement of this figure reflects concern about the Western perception of GDR financial problems.

Preliminary data for inner-German trade show that the GDR's trade surplus is continuing to grow. The cumulative deficit under the "swing" facility fell to 3.4 billion DM at mid-year. The composition of GDR imports reflects the ongoing domestic adjustment and shifts in relations with other trading partners: GDR imports of machinery fell sharply given cutbacks in domestic investment, and the renewed shipments of Polish coal allowed the GDR to cut its coal purchases in West Germany. Offsetting these two developments were increased GDR imports of agricultural goods (mainly grain and fodder) no longer as available from the United States and larger imports of non-ferrous metals. The latter stems both from the need to restock depleted inventories and from opportunities to buy at depressed world metals prices.

### Financing questions

The sharp adjustment in the GDR's trade with non-socialist countries has been reflected in the positions of Western commercial banks as reported to the Bank for International Settlements. Altogether, the available trade data and capital flows suggest that the GDR reduced its current-account deficit to $500 million or less in 1981—a dramatic improvement over deficits in excess of $1.5 billion in 1979 and 1980.

In the first quarter of 1982 there was an abrupt contraction of GDR positions with Western banks. The $644 million decline in reserves was more than offset by a $902 million fall in GDR liabilities. Quite clearly, foreign-exchange reserves were being used to repay medium-term debts as well as to cover short-term loans not being rolled-over by commercial banks. Despite evident resistance to medium-term borrowing, the GDR chose not to utilize available credit from the "swing" facility with West Germany. This decision was probably due to political considerations given the negotiations over inner-German relations taking place in the spring. On June 18, a new agreement was announced that will progressively reduce the annual credit availability to 600 million DM by 1985. With the agreement now complete, the GDR may well shift more of its purchasing back to the Federal Republic in order to utilize the "swing." In any case, the GDR is projected to achieve a surplus on current account in 1982 as well as an absolute reduction in its hard-currency debt to the West.

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